Shifts in consumer spending

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The boom in consumer spending, now in its 12th year, has weathered many adverse shocks to the economy, including terrorist attacks, a sharp decline in equity prices, SARS, and the closing of the American border to Canadian beef products. Throughout this time, resilient household demand, which accounts for almost 60% of the nation's gross domestic product (GDP), not only sustained growth but also played a key role in supporting the economy. Over the last 20 years, however, consumer spending and asset holdings have shifted dramatically reflecting changes in taste, lifestyle and the economy. Developments stem from many factors, including demographic change, technological and financial innovation, globalization of financial markets, rising household wealth, and women's increased participation in the labour market.

Twenty years ago, Canadian families tended to put their savings into personal deposits and fixed-term investments. Today, they are investing in mutual funds and other financial investments. An aging population is increasingly seeking retirement products and supplementary health-insurance coverage. The resulting emphasis on longer-term savings products has propelled the demand for financial planning and wealth management.

A more affluent and active population eats more meals away from home and buys vehicles such as minivans and sport utility vehicles that are more versatile than the traditional family car. Faster population and employment growth in suburban areas has also led to more spending on personal transportation services and less on mass transportation.

In recent years, Canadians have been affected more and more by the rapid advance in information and telecommunications technology. Personal computers and the Internet are increasingly changing ways of communicating, acquiring information, and purchasing goods and services.

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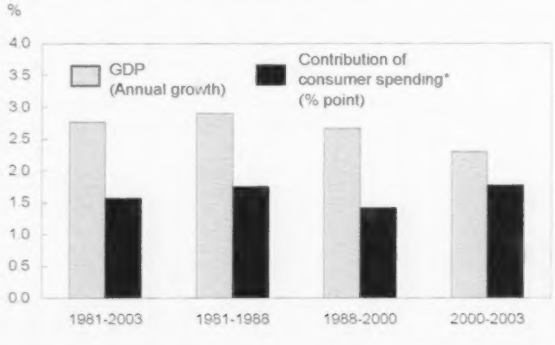
A long-term perspective

Personal consumption expenditures reflect spending to acquire goods and services for the direct satisfaction of individual or collective wants. Attaining higher levels of consumption now or in the future is a major goal of most individuals and a widely accepted indicator of national economic activity. Accounting for 56.3% of GDP in 2003 and contributing more than half of the 2.8% average annual growth in GDP between 1981 and 2003, consumer spending is directly relevant to an assessment of Canada's long-term progress (Chart A).

From 1981 to 2000, the last year before the economy slowed down, real consumer spending grew 2.6% annually, slightly less than GDP. From 2000 to 2003, consumer spending contributed three-quarters of the

Chart A: Consumer spending accounted for more than half of GDP growth.



Source: Income and Expenditures Accounts, 1981-2003
** The rate of growth multiplied by the value share.*

2.3% annual GDP growth—despite several events that adversely affected air transport, high-tech equipment, and new truck and van sales.

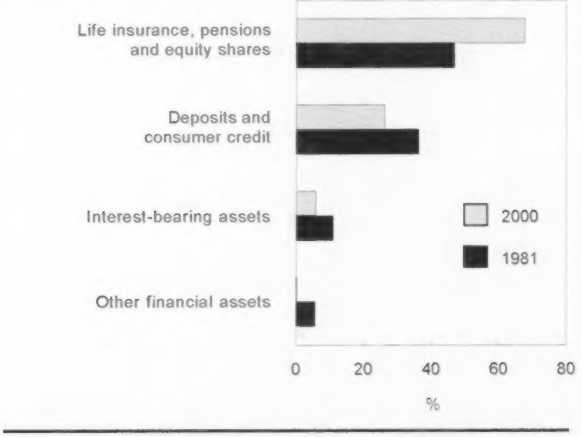
The wealth effect

An increase in real incomes, the accumulation of household assets, and a willingness to take on more debt have resulted in higher consumer spending on discretionary items relative to basic necessities. Between 1981 and 2000, the net worth of households increased at an annual rate of almost 7%, about double the increase in consumer expenditures (3%). In 2000, life insurance and pensions plus stocks accounted for 68% of household financial assets, up from 47% in 1981 (Chart B). This came at the expense of interest-bearing asset holdings (down from 11% to 6%), deposits (36% to 26%), and other financial assets (6% to less than 1%). The most significant change in the composition of assets occurred in RRSPs. The amount in RRSPs in the late 1990s was 6 times larger than in the early 1980s, by far the largest increase of any single asset. This contrasts sharply with total assets, which grew 2 times over the same period. The proportion of families that had RRSPs doubled from 28% to 55%.

Home ownership has also become more important. In 2000, housing accounted for 47% of non-financial household assets, up from 41% in 1981. Generally robust economic conditions and relatively manageable mortgages boosted the housing market, particularly in the second half of the 1990s when housing assets grew at an average annual rate of 4%.

The increase in housing prices in recent years contributed to rising household wealth and helped underpin continued strength in consumer spending. Rising housing prices combined with lower interest rates and financial innovation have increased the borrowing capacity of households. In the past few years, the increase in borrowing secured against housing exceeded net new spending on housing assets. This means that households, in aggregate, have been extracting some of the equity in their homes for other purposes. The same phenomenon has been observed in the United States and the United Kingdom and has been cited as a factor in the growth of consumer spending in those countries.

Chart B: Household financial asset holdings have shifted markedly.



Source: National Balance Sheet Accounts, 1981 and 2000

Financial services

Much of the increase in discretionary spending was for financial services, largely reflecting the increase in household financial assets. Financial services include brokerage charges, investment counselling, accounting services, and bank service charges.

The share of financial services in personal expenditures increased from 0.6% to 2.4% between 1981 and 2000, largely reflecting an increase in the net worth of households and the growing portion of household assets accounted for by financial assets such as pension fund reserves, stocks, mutual funds, and money market funds (Table). During this period, mutual funds increased by 23.5% annually on average, the fastest-growing item in the consumer household basket.

Faster, better and cheaper

Over the period from 1981 to 2000, technological innovations resulted in a proliferation of new goods and services, including cable television, computers, electronic toys and games, cellular telephones, video equipment, and Internet services. Innovation also lowered the prices of many of these items, as well as those of more established goods and services such as audio equipment and long-distance telephone services. The new products increased their share from 1.5% to 3.6%, one of the fastest growth rates within the consumer basket (Table). During this period, computer purchases experienced the second most rapid growth after mutual funds (21.8% compared with 23.5%).

Table: Consumer spending by category

	Average annual growth rate (%)*			Shares**	
	1981-2003	1981-2000	2000-2003	1981	2000
	Chained Constant Prices			%	
Consumer spending	**2.7**	**2.6**	**3.1**	**100.0**	**100.0**
Food, beverages and tobacco	0.8	0.8	1.2	18.4	13.0
Clothing and footwear	1.8	1.5	3.8	6.7	4.6
Gross rent, fuel and power	2.7	2.7	2.8	21.2	22.7
Furniture, furnishings and household equipment and maintenance	**2.6**	**2.3**	**4.4**	**9.9**	**8.1**
TV sets, video equipment and accessories	9.4	8.8	13.0	0.6	0.5
Office machines and computer equipment	18.6	21.8	0.4	0.1	0.5
Medical care and health services	**3.9**	**3.8**	**4.6**	**3.3**	**4.9**
Medical care	4.9	5.1	3.4	1.7	2.3
Hospital care and the like	1.8	1.4	3.9	0.2	0.2
Other medical care expenses	4.9	5.1	3.4	0.4	0.7
Drugs and pharmaceutical products	4.7	4.5	6.0	1.1	1.7
Transportation and communications	**2.9**	**3.0**	**2.5**	**15.7**	**16.9**
New trucks and vans	9.4	10.4	3.6	0.6	2.3
Intercity and rural bus	-1.9	-2.2	0.3	0.2	0.1
Air transport	0.8	1.8	-5.3	1.2	1.2
Telecommunications	6.2	6.2	6.3	1.6	1.9
Education, finance, recreation and culture	**4.7**	**4.7**	**4.5**	**8.4**	**11.1**
Universities	2.9	2.6	5.2	0.2	0.5
Private schools	6.0	6.5	2.7	0.2	0.6
Other educational and cultural services	-3.0	-3.7	1.0	0.4	0.1
Meals outside the home	2.0	2.1	1.4	5.2	5.1
Stock and bond commissions	3.3	4.2	-2.4	0.3	0.4
Mutual funds	20.3	23.5	1.7	0.0	1.4
Legal, accounting and other services	3.6	3.6	3.5	0.3	0.4
Welfare and charitable organizations	6.7	6.8	6.4	0.4	0.8
Religious organizations	2.7	2.8	1.9	0.7	0.7
Cable and pay television	5.7	5.4	7.2	0.2	0.7
Miscellaneous goods and services	**3.2**	**3.3**	**2.4**	**16.2**	**19.0**

Source: Income and Expenditures Accounts, 1981-2003
* *Constant dollars.*
** *Current dollars.*

Telecommunication products and services grew 6.2% annually over the last two decades, compared with 8.8% for television sets and 5.4% for cable TV. This largely reflected an increase in the average number of lines per household, cellular phones, long-distance services, and new convenience services such as caller ID, call-forwarding, and call-waiting. The increased use of cellular phones reflected both increased availability of cellular services and sharply decreasing rates. The increased use of long-distance services was due partly to much lower rates as a result of technological advances and the restructuring of long-distance service providers in the mid-1990s.

Canadians have often been quick to take up new consumer technologies. The number of households connected to the Internet grew rapidly between 1997 and 2002, jumping from 16% to 51%. Over the same period, household ownership of computers also increased, although not as strongly as use of the Internet (Chart C).

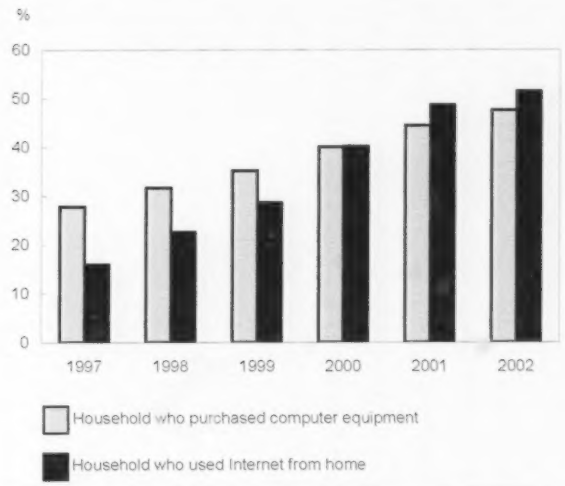
Health and education

Another important feature of consumer spending over the last 20 years has been the rapid increase in spending for health care (5% per year). This was primarily a result of increased third-party payments from private health insurance and public programs, reflecting both an aging population and the increased number of elderly.

While Canada's health care system provides universal medical care, not all expenses are covered by the various provincial plans. Most households make out-of-pocket expenditures for things such as health insurance, eye care, and prescription or non-prescription medications and pharmaceutical products. As a result, the share of consumer spending dedicated to health care increased from 3.3% to 4.9% between 1981 and 2000 (Table).

Although health care expenditures accounted for a relatively small share of the average household budget, almost every Canadian household (98.2%) reported such spending in 2000. The average was close to $1,400, with the largest shares going to health insurance premiums and dental care. By contrast, 20 years earlier, the figure was about $900 (1997 dollars).

Chart C: Internet use has expanded dramatically in recent years.



Source: Household Internet Use Survey; Household Spending, 1997-2002

The share for educational services advanced from 0.8% to 1.4%, reflecting the combination of the increased value placed on college education and rising tuition fees. College enrolment increased at an annual rate of 3.7% between 1981 and 2000, more than triple the 1.1% increase in the population.

Household spending for private schools experienced a rapid 6.5% annual growth during the period. Some 5.6% of children in the late 1990s attended a private elementary or secondary school, up from 4.6% a decade earlier. In contrast, despite a sharp increase in university tuition fees over the last two decades, household spending for university education advanced at only 2.6%. This may reflect an increase in the contribution of students to the expenses related to their postsecondary education.

Transportation

The movement of people from home to work depends on the availability of efficient and affordable public transportation as well as a road network for private vehicles.

Household spending on transportation in 2000 rose to an estimated $7,000 (in 1997 prices), up 7% from 1981. This was due largely to a 10% annual increase in the purchase of cars and trucks (which includes vans and sport utility vehicles). In 2000, the proportion of households purchasing trucks and vans reached 8%, up from 7% in 1997. In contrast, the proportion purchasing cars remained at 14%. Levels of car ownership are affected by many factors, including income, interest rates, car prices, and demographic trends. As cars are often shared within a household, a trend to more single-person households is likely to boost car numbers.

In 2000, households spent an average of $350 on air transport, the largest component of public transportation. This was a 3% increase from 1997, after adjusting for inflation. The increase largely reflected more purchasing of airline services as consumers took advantage of discount fares after the restructuring of the airline industry, as well as greater use of travel agency services.

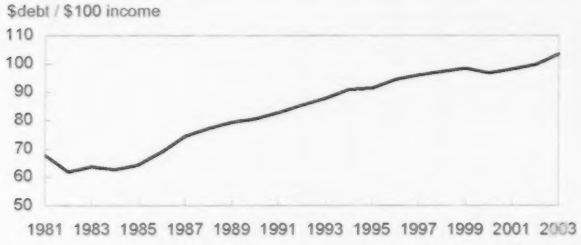
Recent years

The slowdown of the economy in 2001 was marked by a major correction of corporate-sector investment demand, while household-sector spending (consumption and housing investment) remained unusually strong. As the bull market of the 1990s turned into the bear market of the early 2000s, households reallocated their assets.

Although consumer spending generated much of GDP growth during the 2000-2003 period, GDP grew more slowly than during the 1995-2000 period (3.1% annually compared with 3.6%). This slower growth in recent years is mainly attributable to slower growth or pullbacks in a number of industries: air transport (-5.3%), new trucks and vans (3.6% compared with 10.4% during the 1981-2000 period), financial services (1.7% for mutual funds compared with 23.5%; -2.4% for stocks and bond commissions compared with 4.2%), and office machines and computer equipment (0.4% compared with 21.8%).

In addition, consumer spending has been supported by a reduction in personal taxes between 1999 and 2000 (from 21.7% of total expenditures to 20.0%) and low central bank interest rates over the past three years. The Bank of Canada's lowering of the prime rate from 5.74% in 2000 to 3.18% in 2003—a 45% decline in three years—has spurred successive waves of mortgage refinancing and borrowing based on home equity, thus releasing substantial financial resources to fund consumer spending. In addition, households have increased their borrowing through use of credit cards

Chart D: In 2003, households had $103 of debt to every $100 of disposable income.



Source: National Balance Sheet Accounts; Income and Expenditures Accounts, 1981-2003

and short-term personal loans, particularly lines of credit. A steady increase in household debt since the mid-1990s combined with a marked slowdown in disposable income resulted in households in 2003 having $103 in debt (consumer credit and mortgages) for every $100 of disposable income (Chart D). However, low interest rates since 2000 would have moderated the increase in the debt burden.

During the current bear market, households have sharply reversed the more than decade-long trend of increasing their holdings of financial assets. During the period from 2000 to 2003, the share of financial assets experienced a decline—the first since the late 1970s. On balance, households have reallocated their assets away from stocks and investment vehicles toward tangible assets, such as housing and durable goods (Chart E).

Conclusion

Changes in household consumption patterns reflect tastes, preferences, technological development, and the structure of the economy. In Canada, as in many other industrialized economies, consumer spending accounts for about 60% of GDP. Understanding consumer behaviour is therefore paramount in analyzing the determinants of aggregate demand.

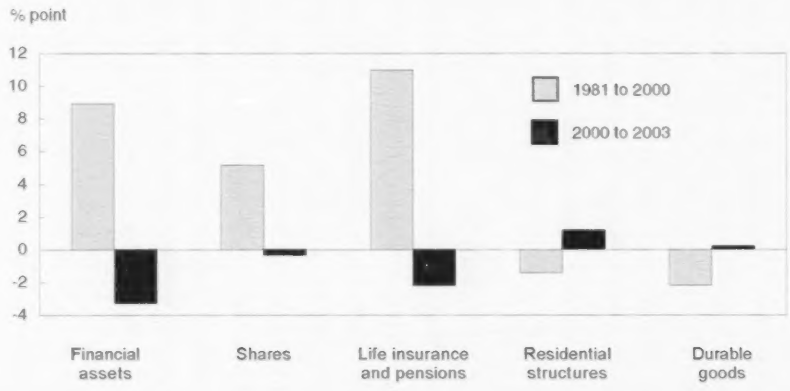
The strength of consumer spending is closely related to increases in personal incomes and wealth. Households have benefited from the rise in housing and stock markets over the past decade, with housing and equity share wealth rising by $307 billion and $330 billion respectively between the end of 1995 and 2003. These two assets alone contributed to slightly more than 20% of household wealth increase during this period.

Some observers, however, have viewed the surge in consumer spending with apprehension. The personal savings rate has fallen to historic lows, consumer debt levels have risen, and the household home equity ratio has dropped to an all-time low. This has led to concern that the rise in private consumption may not be sustainable and that a subsequent weakening could throw the recovery off track. Fears have especially been expressed that consumers could be exposed to a collapse of what many view as a housing 'bubble', given the spectacular increase in real estate prices in some markets.

Perspectives

This study does not incorporate the May 2004 revision to the System of National Accounts data.

Chart E: In recent years, households have shifted to tangible assets.



Source: National Balance Sheet Accounts, 1981-2003